

**REVIEW OF THE
OFFERS IN COMPROMISE PROGRAM**

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This report has cleared the Treasury Inspector General for Tax Administration disclosure review process and information determined to be restricted from public release has been redacted from this document.

Redaction Legend:

1 = Tax return/Return information

3d = Identifying information - Other Identifying Information of an Individual or Individuals

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Executive Summary

An Offer in Compromise (OIC) is a collection tool used in situations where it is unlikely that amounts owed can be collected in full. The OIC can provide a delinquent taxpayer with a fresh start toward compliance.

IRS records show that the number of OIC's received over the years has drastically accelerated, from 9,000 in 1990 to just over 114,000 in 1997. Practitioners and stakeholders have criticized the program for the high number of OIC's that are returned to taxpayers as "unprocessable". Even though IRS introduced a new OIC package in 1997 to help address this problem, the number of "unprocessable" OIC's continues to be a concern.

We initiated this review at the request of management to help address concerns over the adequacy of investigations, high number of OIC's returned to taxpayers as "unprocessable", and timeliness of rejection decisions.

Results

Our review identified the following opportunities for enhancing the effectiveness of the OIC Program and for further promoting fair, consistent taxpayer treatment.

- **The risk of accepting questionable OIC's needs to be reduced.** Our analysis of 289 cases identified 125 cases (43%) in which the adequacy of the investigation is questionable. 1, 3d-----
1, 3d-----However, the investigation was not expanded to probe for unreported income or overstated expenses even though either of these conditions could significantly impact the decision to accept or reject the OIC. To reduce the risk of accepting questionable OIC's, we believe examiners need to be better prepared to conduct OIC investigations and that quality controls need to be expanded.
- **"Processability" determinations need to be standardized to avoid any perception that taxpayers are treated unfairly.** We found that taxpayers are not always informed of the reasons for an "unprocessable" determination. In addition, districts are using different rules to make their determinations. These practices can lead to taxpayers submitting multiple OIC's and cause an "unprocessable" determination in one district and not another.
- **To expedite rejection decisions, workload management practices could be improved and information from IRS data systems used more.** Almost 57 percent of the OIC's that were rejected between March 1993 and October 1997 became overage during the investigation. Although recent IRS reports indicate there has been improvement, additional actions could be taken to become more responsive to taxpayers. Group

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managers need to make sure their reviews include cases that have been open for extended periods of time and cases with no recent activity. Also, using OIC “specialists” to conduct investigations and accessing automated data systems earlier in the process can impact the timeliness of rejection decisions.

Summary Recommendations

The most fundamental actions needed to reduce the risk of accepting questionable OIC’s are to make sure examiners are knowledgeable of IRS’ automated data systems and how the information can be used to enhance the investigative and financial analysis processes. This could be accomplished by providing mandatory training for OIC examiners that emphasizes assembling and analyzing data from automated systems.

Steps also need to be taken to strengthen specific OIC controls and procedures. Among others that are described later in the report, these steps include (1) using the Collection Quality Measurement System to evaluate samples of accepted and rejected OIC’s, (2) standardizing “processability” determinations, and (3) adopting the practice of using OIC specialists.

Management’s Response

Management agrees with our findings and is initiating appropriate corrective action. The complete response is included as Attachment II.

Objective and Scope

Our objectives and brief descriptions of the main tests performed include:

1. Evaluating a sample of 289 accepted Offers-In-Compromise (OIC's) to determine if investigations are performed in sufficient depth to minimize the risk of accepting fraudulent proposals.
2. Reviewing a sample of 358 "unprocessable" OIC's and analyzing IRS Activity Reports to assess the impact the revised OIC package is having on reducing the number of "unprocessable" OIC's as well as the appropriateness of the determinations.
3. Evaluating a sample of 311 rejected OIC's to identify steps that could be taken to improve the timeliness of rejection decisions.

The districts included in the review enabled us to provide coverage over the four IRS regional areas.

We conducted fieldwork in the Los Angeles, South Texas, Michigan, and Indiana Districts from September 1997 through June 1998. The districts selected for review enabled us to provide coverage over the four IRS regional areas. Our review was conducted in accordance with generally accepted government auditing standards. Attachment I outlines the detailed scope of review.

Background

An Offer in Compromise is a collection tool used in situations where it is unlikely that amounts owed can be collected in full. The OIC can provide a delinquent taxpayer with a fresh start toward compliance with all future filing and payment requirements. IRS records show that the number of OIC's received over the years has drastically accelerated, from roughly 9,000 in 1990 to just over 114,000 in 1997.

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IRS management agreed that problems identified from our review in four district offices would be representative of nationwide problems.

We initiated this review at the request of management to help address some of the concerns surfacing with the increasing volume of OIC's received. Managers in IRS' National Office agreed that problems identified from our review in four district offices would be representative of nationwide problems.

Results

We identified the following areas where steps could be taken to enhance the effectiveness of the OIC Program and to further promote fair, consistent taxpayer treatment.

- Reduce the risk of accepting questionable OIC's.
- Better prepare examiners to perform OIC investigations.
- Expand quality controls to identify and resolve problems faster.
- Standardize "processability" determinations to avoid any perception that taxpayers are treated unfairly.
- Expedite rejection decisions by improving workload management practices and using information from IRS data systems more.

The risk of accepting questionable OIC's needs to be reduced.

Each accepted OIC is subject to at least one level of quality review. The group manager is primarily responsible for investigative quality and is required to review and approve each case. Subsequently, an IRS attorney may also evaluate the proposal before it is formally accepted.

We reviewed 289 OIC's that were listed as accepted in the 1997 Automated Offers-In-Compromise (AOIC) database. Using the information in the case file and internal sources of financial information, we analyzed each investigation to

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determine if it was performed in sufficient depth to minimize the risk of accepting fraudulent proposals.

We questioned the adequacy of the financial investigation in almost one-half of the cases reviewed.

Our analysis of the 289 cases identified 125 (43%) in which the adequacy of the investigation is questionable. The 289 cases involved over \$33.45 million of liabilities. The specific problems can be categorized into the following three trends.

1. Probes for unreported income or overstated expenses were not adequate (25 cases). Tests were not documented to explain large discrepancies between income and expenses. 1, 3d-----
1, 3d-----

2. Assets and/or reported income were not properly considered in determining collection potential (84 cases). Tests to determine the acceptable OIC amount were not adequate. 1, 3d-----
1, 3d-----

3. Sources to pay OIC amounts were not adequately considered (25 cases). In these cases, the OIC amount was not paid and the steps taken to verify the existence of the funds were not adequate. Adequate consideration would involve obtaining evidence from third party sources when funds are to be obtained from a friend or relative.

Steps need to be taken at the examiner and quality control levels to improve OIC investigations.

Our evaluation of the exception cases indicates that a combination of factors is causing the problems. We believe examiners could be better prepared to conduct OIC investigations and that quality controls could be expanded.

Examiners could be better prepared to conduct OIC investigations.

Most of the problems we identified on our case reviews involved obtaining and evaluating taxpayer financial information. During our review, we used the following IRS automated information systems to expedite our review of cases. We did not always see that examiners used these resources during investigations.

IRS data systems could be better used to obtain and evaluate taxpayer financial information.

- **Corporate Files On Line System.** This system provides on-line access to nationwide account and tax return data on the Master File. The system can identify the taxpayer's age, income sources for several years, as well as ownership of depreciable assets and real property.
- **Transcript Research System.** This system can be used to help analyze the taxpayer's financial condition by identifying debts owed to other federal or state agencies, other liabilities determined to be uncollectable, bankruptcies, and income history.
- **Locator Services.** These systems provide access to real property and Department of Motor Vehicles (DMV) records to help verify the accuracy of taxpayer financial statements.
- **Currency and Banking Retrieval System.** This is a financial data retrieval system that can be used in the detection of unreported sources of income. The system provides access to Currency Transaction Reports (Form 4789), Currency Transaction Reports by Casinos (Form 8362), Reports of Cash Payments Over \$10,000 Received in a Trade or Business (Form 8300) and Reports of Foreign Financial Accounts.

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Making better use of internal data sources may help to further reduce the burden of the OIC process on the taxpayer.

Using automated information systems to assist in OIC investigations can provide fast, reliable sources of information for verifying the accuracy of taxpayers' financial statements. At the same time, using these internal sources more may help further reduce taxpayer burden by minimizing the amount of information requested from the taxpayer.

Recommendation #1: Take actions to make sure examiners are knowledgeable of IRS' automated data systems and how the information can be used to perform better OIC investigations. These actions could include mandatory training for examiners (revenue officers) that emphasizes assembling and analyzing data from automated systems to enhance the investigative and financial analysis processes.

Management's Response: *Management is implementing a policy of having OIC specialists work all OIC cases. They will also develop new training material that will emphasize assembling and analyzing data from automated systems to enhance the investigative and financial analysis process.*

Quality controls could be expanded to identify and resolve problems more effectively.

Our review shows that managers are reviewing and approving each OIC. An IRS attorney also evaluated many of the cases. However, neither of these reviews detected the problems identified in our case reviews. The primary difference between the District's reviews and Internal Audit's reviews is the information sources used to evaluate the cases.

To make our reviews, we used the previously discussed internal data sources to assemble files that included tax return, real property, and DMV information. The information gave us a more complete picture of the entire case. Managers and IRS attorneys were limited to the

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information contained in the OIC case files to make their evaluation.

CQMS (Collection Quality Management System) is another method that could be used for determining whether examiners are performing their investigations in sufficient depth. One objective of CQMS is to evaluate samples of Collection work to identify managerial, technical, and procedural problems and serve as a basis for corrective action. Unlike many important aspects of Collection work that can be selected for CQMS review, OIC cases are not routinely subject to the sampling process.

Recommendation #2: Take action to make sure that all reviewers, including managers, are knowledgeable of IRS data systems and how the information can be incorporated into the review process. This action could include mandatory training for reviewers that emphasizes how the data assembled from automated systems by examiners can enhance the review process.

Management's Response: *Management is implementing a policy of having OIC specialists work all OIC's. The use of OIC specialists and group managers will allow targeted training. Management will also develop new training material for OIC specialists and new review procedures for OIC group managers.*

Recommendation #3: Forward a representative sample of accepted OIC cases to CQMS to help make sure data from automated systems is assembled and analyzed in sufficient depth to enhance the investigative and financial analysis processes.

Management's Response: *Management is developing a system to forward closed OIC cases to CQMS. They will also develop the OIC review criteria for CQMS.*

“Processability” determinations need to be standardized to avoid any perception that taxpayers are treated unfairly.

We believe more can be done to reduce the number of “unprocessable” OIC’s.

Even though the new OIC package introduced in 1997 was intended to help stem the tide of OIC’s returned to taxpayers as “unprocessable”, the numbers continue to give cause for concern. IRS statistics show that over 49 percent of OIC’s submitted in fiscal year 1998 (through May) have been returned as “unprocessable”. In addition, evidence from the AOIC database suggests that a number of “unprocessable” OIC’s may involve taxpayers making two or three submissions before their OIC can be processed.

To help identify steps that may need to be taken to further reduce the number of “unprocessable” OIC’s, we evaluated a sample of 358 OIC’s returned to taxpayers between July 1997 and December 1997. Our results show that examiners generally supported their “unprocessable” determinations. However, they did not consistently identify all the reasons for the determination and were using locally developed rules that deviated from national guidelines.

In 64 of the 358 (18%) OIC’s reviewed, one or more reasons for the “unprocessable” determination were omitted from the letter explaining the determination to the taxpayer. In these instances, it is reasonable to assume that a portion of taxpayers may have to make repeat submissions as one problem is corrected only to have the OIC returned for a different problem.

In three of the four districts reviewed, we found that examiners were using locally developed rules to make “processability” determinations. The local rules required examiners to use a 60-month period rather than a present value factor and/or adjust taxpayers’ expenses to evaluate the minimum acceptable OIC amount.

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National guidelines need to be followed to avoid any perception that IRS treats taxpayers inconsistently.

According to National Office, both of these practices are prohibited primarily because changing financial information before an OIC has been accepted for investigation may deny taxpayers their appeal rights. In our sample of 358 cases, we identified 84 applicable cases returned to the taxpayer as “unprocessable” after expenses were adjusted or a 60-month period was used to evaluate the minimum acceptable OIC amount.

On a larger scale, our concern is that using different rules to make “processability” determinations could cause an “unprocessable” determination in one district and not in another. To determine if this happened in our sample cases, we used the national guidelines and recomputed the minimum acceptable OIC amount in the 84 applicable cases.

Our results showed that 20 of the 84 OIC’s (24%) could have been accepted for investigation rather than returned to the taxpayer as “unprocessable”. In the remaining 64 cases, the taxpayer was provided erroneous information that can be directly attributable to either adjusting financial information or using a 60-month period to evaluate the adequacy of the OIC.

We traced these problems to locally developed worksheets that were developed using incorrect assumptions. The worksheets did not require examiners to identify all the reasons to support their determination. In addition, the local worksheets incorrectly assumed expenses could be adjusted and a 60-month period could be used to evaluate OIC’s during “processability” determinations.

Recommendation #4: Take actions to make sure “processability” determinations are standardized and that all reasons for the determination are communicated to taxpayers on a more consistent basis. These actions could include clarifying the IRM to provide additional specific guidelines and/or examples on how “processability” determinations should be made and communicated to the public.

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Management's Response: *Management plans to reduce the "processability" criteria to two elements, bankruptcy and compliance. They will also eliminate the use of local deviations. Management envisions that the reduction of criteria in conjunction with the move to OIC specialists will provide consistency in the application of "processability" criteria.*

To expedite rejection decisions, workload management practices could be improved and information from IRS data systems used more.

The statutory period for collecting taxes associated with an OIC is suspended while IRS decides whether to accept or reject the proposal. With the statute suspended, untimely rejection decisions can create the appearance that IRS is unresponsive to taxpayers' needs. From a taxpayer's viewpoint, personal plans may have to be put on hold for an unnecessary extended period of time, particularly if liens are attached to their property.

There are periods of inactivity in 63 percent of the rejected cases we reviewed.

The four districts in our review had 2,189 rejected OIC cases open for six months or more on the AOIC database during the period from March 1993 to October 1997. This represents a 57 percent overage problem. We reviewed 311 of the rejected cases and identified 196 cases (63%) with numerous periods of inactivity ranging from 15 to 673 days. Fifty-five percent (172 of 311) of the cases had one or more periods of inactivity that lasted 60 days or more.

Our analysis of the exception cases did not identify a single predominant cause for the untimely decisions. Instead, our evaluation surfaced two concerns that point to workload management practices and the use of information from IRS' data systems as probable causes for the delays. We believe that:

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- Workload management practices could be enhanced by increasing managerial involvement in cases that have been open for extended periods of time and expanding the practice of using “specialists” to work OIC cases.
- Information on IRS’ automated data systems needs to be timely obtained and reviewed by examiners on a more consistent basis.

Workload Management Practices

One of the responsibilities of Collection managers is to make sure that OIC’s are timely worked. To assist managers meet this responsibility, guidelines recommend reviewing cases that have been in process and/or have no activity for extended periods, and reaching an understanding with the employee on what needs to be done to close the case. Except for signatures on the rejection letter, we found very few instances of documented managerial involvement in the cases.

One of the four districts included in our review used revenue officers assigned to field groups to work OIC’s. The revenue officers in this district are responsible for balancing their workload between OIC’s and other cases such as delinquent account and return investigations.

The other three districts we reviewed adapted the practice of using OIC “specialists” by the end of 1997. As the name implies, OIC “specialists” are responsible for working OIC cases almost exclusively. According to officials, this practice helps deliver the program in a more consistent manner and provides a way to better tailor training needs for specific groups of employees.

Our analysis suggests OIC “specialists” may help close overage cases faster.

To evaluate the impact that OIC “specialists” may have on the timeliness of rejection decisions, we used the fiscal year 1997 AOIC database and analyzed the overage cases (open more than 180 days) from each district included in the review. We found that the districts using specialists not only

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had a slightly lower percentage of overage cases but also closed their cases faster once they became overage. Below, Chart 1 graphically compares the median days spent to close overage cases by District Office #1 (DO #1) to the other three districts in our review. DO #1 did not have offer specialists at the time our sample cases were investigated.

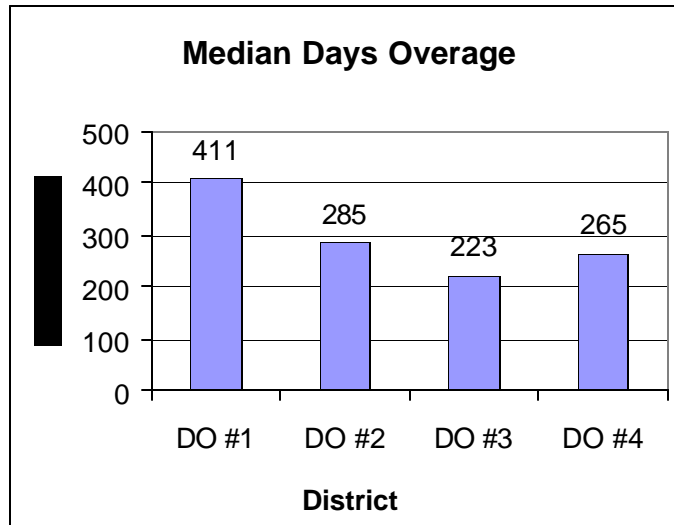


Chart 1

Using information from IRS' data systems more.

Many of the delays we identified can be attributable to problems with verifying the accuracy of items reported on taxpayer financial statements and potential nonfiler situations. In several instances (72 of 172 exception cases), we believe the rejection decision could have been made sooner by timely obtaining and reviewing information on IRS' automated data systems.

1, 3d-----

1, 3d----- However, we reviewed information from Corporate Files On-Line System and found that the same conclusion could have been reached on or before October 1995.

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Taxpayers submitting an OIC, that have not filed all returns, need to be addressed before steps are taken to investigate their financial information.

In several other cases, the OIC was appropriately rejected after it was determined that the taxpayer had not filed all returns. In these instances, it seems pointless to perform the OIC investigation since the taxpayer's entire liability may not be reflected in their OIC. As a result, taxpayers that have not filed all returns could be identified during "processability" determinations and their OIC returned before steps are taken to investigate their financial condition.

Recommendation #5: Take actions to increase management involvement in OIC cases. These actions could include a memorandum to managers emphasizing existing requirements.

Management's Response: *OIC specialists, working under OIC group managers, will work all OIC's in all districts. Management believes these actions will increase the amount of management involvement in OIC cases.*

Recommendation #6: Adopt the practice of using OIC specialists in those districts that are assigning OIC cases to examiners (revenue officers) who also work other delinquency investigations.

Management's Response: *Management will implement the use of OIC specialists in all districts.*

Recommendation #7: Take actions to make sure examiners are knowledgeable of IRS' automated data systems and how the information can be used to expedite rejection decisions. These actions could include mandatory training for examiners (revenue officers) emphasizing the use of IRS data systems to speed-up rejection decisions.

Management's Response: *Management will develop new training material that will contain information on the use of automated systems. The training will focus on using automated systems to make appropriate collection decisions.*

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Recommendation #8: Take actions to make sure taxpayers that have not filed all returns are addressed prior to starting OIC investigative activities. These actions could include using IDRS to screen for nonfilers during “processability” determinations and returning OIC’s submitted by nonfilers before investigations are initiated.

Management’s Response: *Management has reduced the processability criteria to two elements, bankruptcy and compliance. Under compliance, the taxpayer’s offer will not be processable if all required returns have not been filed. IDRS will be used to screen for nonfilers during the processability determination.*

Recommendation #9: Forward a representative sample of rejected OIC cases to CQMS to help gauge the extent of managerial involvement and use of automated systems.

Management’s Response: *Based on the increased workload going into CQMS, management will not be able to include rejected OIC’s into the review sample for some time. Instead, management will use the independent administrative review of rejected offers to assess managerial involvement and the use of automated systems until procedures can be developed to review rejected OIC’s in CQMS.*

Conclusion

We believe this report provides observations and recommendations to enhance the effectiveness of the OIC Program, particularly in the areas of:

1. Protecting revenue by reducing the risk of accepting questionable OIC's.
2. Reducing the burden of OIC investigations on taxpayers by making better use of internal data systems in a manner that will minimize the need to request personal and financial data from taxpayers.
3. Promoting fair, consistent taxpayer treatment by standardizing "processability" determinations.

Frank Dunleavy
Audit Manager

Staff Assigned

Senior Auditor: Stanley Pinkston

Referencer: Larry Wyrick

Auditors:

Tom Cypert

Bill Denson

Debra Dunn

Michelle Griffin

Mark Judson

Jean Kao

Mike Laird

Anthony Snowden

Mike VanNevel

Detailed Scope of Review

The review included the following objectives and related tests that were primarily conducted in the Los Angeles, South Texas, Michigan, and Indiana Districts. The districts selected enabled us to provide coverage across the four IRS regional areas.

- Evaluated a sample of 289 accepted OIC's using the information in the case file, supplemented with information from available automated data systems, to determine if the districts included in the review performed investigations in sufficient depth to minimize the risk of accepting fraudulent OIC's.
- Compared the August 1997 OIC activity report to the June 1998 report (through May 1998) to assess the impact the revised OIC package had on reducing the number of OIC's returned to taxpayers as "unprocessable".
- Reviewed a sample of 358 OIC's returned to taxpayers between July 1997 and December 1997 to determine if the decision made by the districts included in the review was appropriate and if steps could be taken to reduce the number of "unprocessable" OIC's.
- Evaluated a sample of 311 OIC's rejected during investigations between March 1993 and October 1997 to determine if the actions could be taken by the districts included in our review to improve the timeliness of rejection decisions.

Management's Response